

# **THE ZIMBABWE JOURNAL OF ECONOMICS**

**(Formerly The Rhodesian Journal of Economics)**

Editors: A.M. Hawkins, J.A.C. Girdlestone and J.M. Robertson

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## NATIONAL POLICY ON INCOMES, EMPLOYMENT, PRICES AND PROFITS -

### The Economics of Increasing Inequality.

Samuel Victor Chirvoka\*

In attempting to follow optimal strategies of development, countries often make crucial decisions on issues affecting the allocation of resources between present and future wants, or between private and public wants. These decisions might adversely affect the distribution of income among the different income groups, which would inevitably lead to conflicts among them.

To avoid such conflicts, governments could try to incorporate some form of income redistribution in their policies. This, ostensibly, will be to put the whole economy into tune as it were, i.e. to prevent some government policies being frustrated by uncontrolled "market" forces which could distribute income in an undesirable manner. The conflicts might not be completely avoided all the same, because people in Government belong to some class in the society, hence their decisions could be biased towards their own class interests. The government of the Republic of Botswana is an example in this attempt to equitably distribute income.

This paper discusses one policy of government aimed at income distribution, the "National Policy on Incomes, Employment, Prices and Profits" (hereafter the Incomes Policy). The Incomes Policy's aims are discussed and evaluated. Conclusions reached could be a pointer to the results we should expect from continued implementation of the Incomes Policy.

### Reasons behind the Establishment of the Incomes Policy

The Botswana Government published the second of its rolling plans in 1970. This plan aimed at:

- a) securing the fastest possible rate of economic growth to raise living standards;
  - b) achieving financial independence;
  - c) securing rapid expansion of employment opportunities;
- and
- d) promoting an equitable distribution of income and wealth in the country.

These aims are self-explanatory. The government recognized<sup>(1)</sup> that to achieve all the four aims, the levels of wages, prices and profits should be within certain desirable limits. This is indeed true because uncontrolled increases in earnings of different income-groups could be in conflict with these goals set by government. Some income earners could increase their earnings more rapidly than others, and though this could be consistent with rapid economic growth, it will be in conflict with the aim of equitably distributing income and wealth.

To set the limits beyond which all types of incomes cannot reach, the government

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instituted the Incomes Policy. Its aims were as follows:

- to maximize the growth of new job opportunities;
- to prevent a widening of the gap in living standards between those in formal sector jobs and those dependent on traditional agriculture;
- to prevent government's scarce financial resources from being directly or indirectly pre-empted by the modern sector.<sup>(2)</sup>

Some salient facts were presented in the Incomes Policy document which provided a backing to the government's fears and hence establish necessity for the Incomes Policy. First, it was pointed out that labour was highly mobile in Botswana due to seasonal factors and patterns of rain. The government warned that more people would come to the urban areas if wages were allowed to rise rapidly. Secondly, it was pointed out that there was a high wage differential between urban and rural areas. People in urban areas earned on average between R10 and R20 as against average earnings between R5 and R10 in rural areas.<sup>(3)</sup> Attention was also drawn to the high wage differentials between unskilled and highly qualified technicians - a ratio of 20:1 between the technicians and the unskilled, and a ratio of 4:1 between the artisans and the unskilled workers respectively.<sup>(4)</sup>

With the institution of the Incomes Policy, the government hoped to lower the rate of increases in formal sector wages hence reduce the attractiveness of formal sector employment. This would lower the level of migration from the rural areas to urban areas. Apart from curbing migration, the standards of living in rural areas will be more comparable to those in urban areas as the differential in earnings will have been narrowed.

Moreover, as most government employees are in urban areas, the levelling-off in wage increases would have an effect on the total wage bill of the civil servants. The total wage bill, as an expenditure, will decrease relative to other government expenditures, specifically those in rural areas. More spending in rural areas will create more employment. Low wages create spin-off effects in the form of more jobs created by more attractive investments.

#### Why the Incomes Policy is not a suitable tool to attain the stipulated government goals.

The Incomes Policy has been operative since its institution in 1972. It was part and parcel of the 1973-78 National Development Plan, and it is an integral part of 1976-81 National Development Plan. In fact, the 1976-81 Plan states that, in conformity with the Incomes Policy, "it is not expected that during the Plan period the real incomes of public employees will be increased above their 1976/77 level." <sup>(5)</sup> Since public employee wages set the maximum level of all economy wages, we cannot expect real incomes of all workers in the country to rise above their 1976/77 level during the period to 1981.

We believe that the Incomes Policy cannot bridge the gap between the skilled and the unskilled workers. The reason is that it limits the rates of increase

in wages equally between the wages of the skilled or unskilled. The skilled workers have high wages already, so they will not suffer as much as the unskilled workers. The gap between them stays constant, and it will not be narrowed by this policy. Tripartite Wage Councils which were provided by the Incomes Policy to safeguard the interests of the very low paid, unskilled workers were set up in only five industries. These wage councils were to set minimum wages to be paid. Setting minimum wages does not on its own ensure that the absolute annual increases in wages, for the unskilled and skilled workers, are such as to bridge the gap between their incomes.

We also believe that the Incomes Policy cannot bridge the gap between urban and rural incomes because the urban-rural dichotomy can mainly be seen as one between the unskilled on one hand and the skilled on the other. The unskilled workers are mainly the new arrivals in towns or they could be the seasonal workers with their characteristic high mobility. Hence, they have ties in rural areas. With the extended family system in the country, one can expect them to remit and/or take back home (to the rural areas) most of their earned income from towns. The skilled workers are mainly the expatriates and the old Batswana arrivals in towns. These workers can be expected to remit very little money to the rural areas of Botswana. Their interests lie in towns and/or in foreign countries. We cannot, then, separate the unskilled workers from the rural dwellers, but can separate the skilled workers from both the unskilled workers and the rural area dwellers.

It follows then, that the continuation of the Incomes Policy to the end of 1981 is undesirable from the point of view of the unskilled workers who happen to be the Batswana. Fixing these workers' real wages at 1976/77 levels for the next four or five years robs them of the benefits of their efforts. We can only expect to see an increasing share of real national income going to the skilled category of workers. Besides, we could expect labour mobility to increase from season to season as workers attempt to supplement their real incomes by going back to grow crops during the rain season. In addition, an increasing number of workers could show a preference for work in South Africa rather than in Botswana, because the South African real wages could be increasing relative to those in Botswana.

To clarify these reasons behind our rejection of the Incomes Policy, we discuss its main aims one by one.

#### A. To maximize the growth of new job opportunities

Although cheap labour is an inducement to investors, it is only one of many inducements. Its importance increases as its percentage share of total costs increases. In the extreme case, if wage-costs are 100% of costs, investors would only look to the general level of wages to decide setting up production. In Botswana, less than 30% of all resources are claimed by workers. The other seventy percent of resources go to capital including profits, government, and to raw materials.<sup>(6)</sup> A rational investor would watch the rates of increases in capital costs, taxes and raw material costs before worrying about rate of increase in wages. A government worrying about rates of increase in wages only without looking at the bulk of other costs could find it difficult to attract investors.

Moreover, the fact that there are many unemployed people in less-developed countries does not imply that the level of wages is too high. In less-developed countries, minimizing the rate of increase in wages is not a necessary and sufficient condition for the maximization of the growth rate of new job opportunities. The Incomes Policy apparently implies that if the rate of increase in wages is lowered, the growth rate of new jobs will increase.

The classical economists<sup>(7)</sup> (those economists subscribing to the popular theory prevalent before 1936 when J.M. Keynes published his General Theory of Employment, Interest and Money) believed that massive unemployment is common in situations of overproduction of goods and services. They also believed that overproduction is caused by too high a level of the general price level. To remove both unemployment and the oversupply of goods, the classical economist required a situation where both the prices of goods and services, and also money wages, are completely flexible. In this case both prices and money wages should fall thereby making commodities cheaper. Demand for commodities would rise until aggregate demand is equated to aggregate supply. As money wages fall, producers' demand for workers would increase as it will be cheaper to hire labour, hence employment opportunities would expand.

But, if prices decrease at the same rate as money wages, real wages would remain constant. The more sophisticated classical economists thought that this could impede the expansion in job opportunities. So, the expanded classical argument requires money wages to fall faster than commodity prices. This will ensure a fall in wage costs, hence an expansion in job opportunities.

The fall in money and real wages could be necessary for the expansion of labour employment, but it, ipso facto, decreases effective demand of goods and services by the same wage earners. Once effective demand of commodities starts falling, producers, who are also the employers, will cut down on production, hence unemployment. Downward flexibility in wages cannot increase job opportunities.

The classical economists' mistake was to extend partial equilibrium analysis to the whole economy. It is true that if there is unemployment in one industry, wages in that industry could be decreased. The resulting fall in effective demand by employees of this single industry cannot affect aggregate demand for the output of this industry which is economy-wide. The industry will not, then, be forced to contract because of deficient demand. On the contrary, it can expand effectively because wage costs will be lower and the market will not have been diminished significantly.

This refutation of the "classical" argument further strengthens the argument of derived demand in the whole economy. The concept of derived demand implies that producers can only demand the services of labour provided that what labour produces is bought. By advocating for low wages and salaries to attract foreign investors, the Incomes Policy ignores the concept of derived demand.

Wage earners are the consumers, and if they are subjected to constant real incomes for five years running, they cannot be expected to consume more in future than they consume now. It is likely that producers have analysed the market for most commodities here and concluded that it is not worth setting up because demand is very limited. If they have no "money illusion", i.e. if they

know the true purchasing power of money all the time, money increases in wages without real increases in income will not induce the producers to set up production in Botswana. Those producers who are already producing here will rather not expand their operations. Hence the consumers will continue importing the commodities and the job opportunities will not increase substantially. In this case, the Incomes Policy is self-defeating.

An argument is brought up in the Incomes Policy document that real wages should not be allowed to rise faster than labour productivity lest investment opportunities would be reduced and reduce employment. This is theoretically true. However, for fairness' sake, the workers must get their fair share of productivity growth. The 1976/81 Plan forecasts that GDP will increase by an average of 9,6% per annum while formal employment will grow at about 6% per annum.<sup>(8)</sup> Clearly part of the difference (3,6% per annum) represents increase in productivity of the workers. This increased efficiency of workers is appropriated by other income earners, especially those receiving operating surplus.<sup>(9)</sup>

The Incomes Policy document further says that the rise in wages causes wage inflation, making manufactured goods more expensive but at the same time attracting rural dwellers to towns thereby increasing unemployment and poverty. The authors of the Incomes Policy, here, specifically assume "money illusion" on the part of rural-urban migrants, i.e. although the increases in money wages could be squandered by the resulting increases in the prices of manufactured goods, the rural dwellers will still flock to towns for starvation and unemployment! This is belittling the whole problem facing the poor. The fact that some people choose poverty in towns rather than poverty in the rural areas might mean that poverty in the former is subjectively less intense than in the latter. It does not necessarily mean that such people are irrational. It further points out that there are not as many opportunities for these people both in the rural and urban areas, i.e. in Botswana as a whole. Forcing them to stay in areas with no opportunities (even where they do not hope for any opportunities) by providing no alternatives, is not a solution to the dilemma. It only helps to disguise unemployment and hide the rural majority's suffering from the eyes of the urban-based ruling elite.

The Incomes Policy document rightly mentions the limitations of the Botswana market. This happens to be one of the reasons why most goods are produced abroad. The extent of the market is determined by both the level of population and their purchasing power. In a country with a small population, like Botswana, one can only expand the market by increasing the purchasing power of the residents. To the extent that this is not possible, the country can only look beyond its borders for a larger market if it happens to produce anything. The international market is highly competitive. The need to produce at low cost becomes a necessity. To achieve this the government will indiscriminately make efforts to depress all kinds of costs of production. The easier to control end up bearing the burden, even unfairly. This is the position confronting wages today. But low wages can do very little to price levels if they are only a relatively small percentage of total costs.<sup>(10)</sup> The Incomes Policy succumbs to the dictates of duality of development, where Botswana remains the inferior, periphery country. It cannot produce manufactured goods because it has no large market, and whatever it produces is sold at give-away prices, in order to compete - all at the expense of the workers.

- B. To prevent a widening of the gap in living standards between those in formal sector jobs and those dependent on traditional agriculture.

In developing countries, it is the so-called unskilled workers whose income rises rapidly in an attempt to bridge the gap existing between their lot and the foreign-trained experts. The Incomes Policy is, hence, aimed at the wages of these unskilled workers.<sup>(11)</sup> Also, it has been made clear above that these unskilled workers, who happen to be the majority, are the ones with strong ties with the rural areas because they, usually, are the new arrivals. According to the previous development plan<sup>(12)</sup>, there exists strong family ties in Botswana so that wages of urban labour flow back to rural areas by way of remittances and other forms of support. Since the majority of rural households have very little or no cattle,<sup>(13)</sup> a large percentage of rural incomes derive from urban incomes. If the urban incomes in question are low, the rural incomes derived from them will be even lower.

It follows that if urban wages are kept constant, rural incomes will remain constant at lower levels than urban ones. Rural real incomes might even diminish because, with time, urban workers learn to live at higher standards. They then would remit less and less to their rural based relatives. The gap in living standards will widen, as a result. Government policy will be self-defeating.

Secondly, the Incomes Policy does not effectively control other forms of incomes, like rents and profits, as much as it controls wages. This is so because it is practically simpler to control wages as they are set in contracts embracing thousands of workers at a time. Prices and rents are negotiated on a day-to-day basis involving millions of transactions. This will make it impossible for government to track down all those who disregard price control regulations. In fact, most retail outlets, especially in the car spares sector, arbitrarily fix their own prices.

Workers' productivity is expected to increase during the years 1977 to 1981.<sup>(14)</sup> Someone else will reap the benefits accruing from this increased efficiency of workers. These beneficiaries are mainly the profit earners and those who receive rent. Inequality between the wage-earners and the other income-earners will increase. There is a significant disparity between the income of the garage owner, for example, who lives in Gaborone's Extension Nine (9), and his employee (a car lubricator, or some unskilled artisan helper) who lives in Old Naledi. There is little disparity in income between the car lubricator and his cousin who lives in some village outside town, for instance. No worker in Botswana can claim as much gains from modern development as is claimed by such petty owners of the means of production. There is increasing inequality between unskilled workers (and their rural dweller relatives) on the one hand, and the skilled experts on the other, and the Incomes Policy tends to widen this gap.

- C. To prevent the government's scarce financial resources from being directly or indirectly pre-empted by the modern sector.

The central and local governments together employ the largest number of people



in the country.<sup>(15)</sup> These governments can only be able to increase the number of people they employ and the range of services they offer if their revenues increase. The governments find it hard to increase these revenues because their sources are limited. It follows then, that an increase in cost of either the labour employed by the governments, or the services they offer (or both) will lead to a decrease of services offered or the number of people employed by government (or both).

The assumption in the above reasoning is that the cost of services and/or salaries of government employees rise suddenly with revenue constant, i.e. the percentage increase in government expenditure outstrips the percentage increase in total government revenue. This assumption is not likely to be true in a country with a progressive tax system. Studies undertaken in the United States<sup>(16)</sup> show that if the rate of inflation is equivalent to the rate of money income growth (leaving real income constant), a progressive tax structure will cause income earners to receive about one-third less of their after-tax real incomes. The taxpayers lose more in situations where inflation rates outstrip money income growth. The fall in taxpayers' real income, *ipso facto*, means a gain in real government revenue by at least a third of the real revenues the government received in the previous period. This is true in countries where taxed incomes are not indexed for inflation, i.e. income earners automatically receive some percentage of their income which compensates their loss due to inflation each year. This does not happen in Botswana.

The Incomes Policy's third aim, hence, is based on a false premise. The truth is that real government revenues are not likely to be pre-empted by rising civil servants' salaries as long as the percentage increase in salaries is below the inflation rate. Rates of inflation are so high that they would outstrip even reasonable annual increases in money wages so, we expect the governments to get more and more revenues from income earners through inflation, just as we expect them to get more through the widening of the tax base as more and more people become employed. The progressive nature of the income tax structure pushes more and more people into higher tax brackets, and this directly boosts government revenues. The statement, that it is expected that civil servants will get a 1981 real income whose level is not above the 1976/77 level, conceals a lot of truth. This is so because it does not take into account the effects of progressive income taxation and inflation on wage-earners' real income. All taxpayers will be getting lower real incomes in 1981 than they received in 1976. Taxation will have pre-empted the civil servants' salaries, and not vice-versa!

#### SUMMARY

The Incomes Policy should not have remained operative for more than one planning period. We hold this view because we believe that the less-skilled workers stand to lose the benefits of their increasing efficiency under the Incomes Policy. Already the 1976-81 Development Plan projects a non-increasing real level of workers' incomes in the urban areas.

We do not believe that the Incomes Policy will maximize the growth rate in job opportunities during the 1976/81 Development Plan or indeed during any period. This is so because the Incomes Policy contradicts some basic entrepreneurial attitudes, i.e. one can only produce more provided one is assured of a market

for one's product. If the market is constant or even shrinking, a producer cannot produce more, hence he cannot employ more labour. The market is made up of the workers themselves. The workers' real income is not projected to increase from 1976 to 1981. It might, in fact, fall. Hence producers will not set up manufacturing units in the country because the market is very small. Without any firms setting up there will be nobody employing the people here, hence job opportunities will not increase at the desired rate.

Secondly, we do not envisage the gap in living standards between the unskilled urban worker and the rural dweller widening. These two are attached to each other through the extended family system and they share the little the other gets from urban employment. Instead, we envisage a widening gap in the living standards between the skilled and property owners, on the one hand, and the unskilled workers and the rural dwellers, on the other. This is what we view as "increasing inequality". The reason for this happening is that the Incomes Policy can keep wages only, constant (i.e. wages of the already poorly paid people) not rents, interest, profits and prices. The salaries of the skilled workers and proprietors are already high.

Thirdly, we attempted to demonstrate the fallacy of Government revenues being pre-empted by increases in civil servants' salaries. Inflation and progressive income taxation work, unflinchingly, to see that government revenues are not pre-empted, but the Incomes Policy has actually ensured that the consumer's purchasing power will continue to be pre-empted by taxation. The earners of this income, which is continually being eroded, are also the breadwinners for the majority in the rural areas. Faced by an impossible situation where they might fail to feed themselves, we can only expect them to stop supporting their rural-based relative, thereby destroying one of the important customs - the extended family system.

On the whole, we contend that urban labour in Botswana is made to bear the cost of increasing the competitiveness and profitability of the businesses unnecessarily. This is so because, although the Incomes Policy was designed to control the increase in wages, salaries, profits, prices and rents, it is difficult to control prices, rents, hence profits in market economies. Prices and rents are negotiated on a day to day basis covering a limitless number of commodities and transactions (e.g. spare parts for cars, rooms or houses for rent etc) not only among residents but also with foreigners. Wages could be settled in a few contracts covering thousands of workers at one time, hence they are easier for governments to control.

FOOTNOTES

1. This paper is based on the National Policy on Incomes, Employment, Prices and Profits, Government Paper No. 2 of 1972. The document explains why it was necessary to institute an incomes policy.
2. Ibid.
3. All figures are quoted from the Incomes Policy document, op. cit.
4. Ibid.
5. Government of the Republic of Botswana, National Development Plan 1976-81, Ministry of Finance and Development Planning, (Government Printer, Gaborone) p.18, para. 2.30.
6. National Development Plan 1976-81, op. cit. p.42, Figure 2.13.
7. For a more detailed Keynesian critique of Classical Economics, see A. Stonier and D. Hague, A Textbook of Economic Theory, 3rd ed. (New York: John Wiley & Sons, Inc. 1964) pp 353-60.
8. National Development Plan 1976-81, op. cit. p.23, para 2.68.
9. Ibid. p.30, Fig. 2.4. Operating surplus increases at the expense of income accruing to Botswana for the period 1976/77 to period 1980/81.
10. See (6) above.
11. Professor Ghai, the consultant on the Incomes Policy, clearly made this point in the document: National Policy on Incomes, Employment, Prices and Profits, op. cit. p.4, para.13.
12. Government of the Republic of Botswana, National Development Plan 1973-78, Ministry of Finance and Development Planning, (Government Printer, Gaborone) p.41, para. 3.32.
13. See National Development Plan 1976-81 op. cit. page 72, para 4.30. About 45% of the rural population have no cattle at all and a further 20% have fewer than 10 cattle.
14. See (8) above.
15. This is stated in the Incomes Policy document, op. cit. p.4. para.15.
16. Federal Reserve Bank of St. Louis, Review, vol.50, No.5, May 1977, in "So what, its only a Five Per cent Inflation", by Leonall C. Andersen, pp.21-23.

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